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MFL International Sdn Bhd v Baharom bin Hamzah

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HIGH COURT (KUALA LUMPUR) — ORIGINATING SUMMONS NO WA-24NCC-270–05 OF 2018
AZIZUL AZMI ADNAN J
29 MARCH 2018

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Contract — Construction — Construction of clause — Interpretation — Proper construction of profit warranty clause in shareholders' agreement — Meaning of the expression '(consolidated) profits after tax' used in shareholders' agreement — Plaintiff and defendant entered into shareholder agreement — Plaintiff alleged defendant breached shareholders' agreement — Whether consolidated after tax profit under profit warranty clause referred to group of companies — Whether plaintiff entitled to exercise call options rights under shareholders' agreement — Whether defendant should pay compensation to plaintiff

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The plaintiff, MFL International Sdn Bhd, was an investment vehicle of a private equity investor. It invested in Romstar Group Holdings Sdn Bhd ('the company'). The defendant, Encik Baharom Hamzah, was the chief executive of the company. The plaintiff sought to enforce the terms of a profit warranty contained in a shareholders' agreement dated 9 November 2015 ('the shareholder agreement') entered into between them and certain other shareholders. The key determination in the present case centred around the proper construction of a profit warranty clause, specifically the meaning of the expression 'consolidated profits after tax' as used in the shareholders' agreement. There was a dispute as to the meaning of this phrase because the company only acquired the shares in its operating subsidiaries on 7 December 2015, whereas the profit warranty operated in respect of the financial years only acquired the shares in its operating subsidiaries from 2014–2016. The consolidated net profits of the company for the financial year 2015, as set out in its audited financial statements, only took into account profits attained by the subsidiaries from the date they were acquired. This figure was, not unexpectedly, appreciably lower than the sum of the net profits of all the three companies put together. The shareholders agreement contained a call option clause, which essentially operated as a warranty by the defendant that the consolidated profits after tax of the company would exceed certain specified thresholds. In the event that the target was not met, the plaintiff would be entitled to acquire, for one ringgit, a certain number of shares from the defendant as the parties expressed in the shareholders agreement, 'to compensate the plaintiff for the over-valuation of the company'. The number of shares was to be determined in accordance with a prescribed formula. If the

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exercise of the call option would result in the plaintiff holding more than 49% of the total ordinary shares in the company, then the defendant was instead required to make a cash payment for the value of such shares in excess of 49%. In other words, the shareholding of the plaintiff would be capped at 49%, as befitting its role as a private equity investor. It was not in dispute that the company failed to meet the agreed profit targets, due to the precipitous downturn in global oil prices experienced in 2014–2016. The plaintiff in the present case applied for: (a) a declaration to the effect that the warranty by the defendant as to the level of consolidated profits after tax of the company as contained in cl 20.1 of the shareholders' agreement had been breached ('prayer (a)'); (b) the defendant was to transfer 4,890,030 shares in the company, pursuant to the exercise by the plaintiff of its call option rights under the shareholders' agreement ('prayer (b)'); and (c) the defendant was to make a payment of RM3,711,340 as compensation for the shares that would have otherwise taken the plaintiff's holdings over 49% ('prayer (c)').

Held, allowing the plaintiff's application in part with cost of RM25,000 subject to payment of allocator:

(1) What was clear was that the parties had intended by the use of the term consolidated referred to the performance of the group of companies and not just to the performance of the company singly. A reasonable person in the positon of the plaintiff and the defendant at the time the contract was entered into would have understood 'consolidated profit after tax' to mean the net profits attained by all the companies comprised in the group, aggregated for that financial year. It should not make a difference to the call option clause when the acquisition was completed, as the purpose of the investment was to obtain the benefits of the economic venture comprised in the four companies as a whole. For that reason, the appropriate figure to be used for the consolidated profits after tax was RM8,059,832 and not RM2,756,457 as contended by the plaintiff. There was no doubt that the audit of the company had been conducted in accordance with the applicable accounting standards. However, the figures arrived at for accounting purposes were not the figures to be used for the purposes of ascertaining the measure of consolidated after tax profits of the company in connection with the call option trigger under the shareholders' agreement (see paras 26 & 47–49).

(2) Applying the appropriate figure to the call option formula, the court determined the number of call shares to be transferred by the defendant to the plaintiff to be 2,612,589 shares. Based on the above findings, the court allowed prayer (a). The court however allowed prayer (b) in part only as the court was of the view that the plaintiff was only entitled to exercise its option to call for 2,612,589 ordinary shares, in accordance with the proper construction of the relevant provisions of the shareholders' agreement. These shares, taken together with the plaintiff's

pre-existing holdings of ordinary shares in the company, would not have resulted in the plaintiff owning more than 49% of the ordinary capital in the company, and hence the court disallowed prayer (c) (see paras 51 & 53).

[Bahasa Malaysia summary

Plaintif, MFL International Sdn Bhd, adalah jentera pelaburan bagi pelabur ekuiti swasta. Ia melabur dalam Romstar Group Holdings Sdn Bhd ('syarikat tersebut'). Defendan, Encik Baharom Hamzah, adalah ketua eksekutif syarikat tersebut. Plaintif memohon untuk menguatkuasakan syarat-syarat waranti keuntungan yang terkandung dalam perjanjian pemegang saham bertarikh 9 November 2015 ('perjanjian pemegang saham') yang dimasuki antara mereka dan pemegang saham tertentu yang lain. Penentuan utama dalam kes ini berkisarkan pembentukan klausa jaminan keuntungan yang betul, khususnya maksud istilah 'consolidated profits after tax' sepertimana digunakan dalam perjanjian pemegang saham tersebut. Terdapat pertikaian berhubung maksud istilah ini kerana syarikat terebut hanya memperoleh saham dalam syarikat subsidiarinya yang beroperasi pada 7 Disember 2015, manakala waranti keuntungan tersebut yang dikendalikan berhubung tahun kewangan hanya memperoleh saham dalam syarikat subsidiarinya yang beroperasi dari 2014–2016. Keuntungan bersih yang disatukan bagi tahun kewangan 2015, seperti yang dinyatakan dalam penyata kewangannya yang telah diaudit, hanya mengambil kira keuntungan yang diperolehi oleh anak-anak syarikat dari tarikh ia diperolehi. Angka ini, tidak disangka-sangka, lebih rendah daripada jumlah keuntungan bersih ketiga-tiga syarikat itu. Perjanjian pemegang saham yang terkandung klausa opsyen panggilan, yang pada asasnya beroperasi sebagai jaminan oleh defendan bahawa keuntungan disatukan selepas cukai syarikat itu akan melebihi ambang tertentu yang dinyatakan. Sekiranya sasaran itu tidak dipenuhi, plaintif berhak untuk memperoleh, untuk satu ringgit, sejumlah saham dari defendan sebagaimana pihak-pihak yang dinyatakan dalam perjanjian pemegang saham, 'to compensate the plaintiff for the over-valuation of the company'. Bilangan saham akan ditentukan mengikut formula yang ditetapkan. Sekiranya pelaksanaan opsyen panggilan akan mengakibatkan plaintif memegang lebih daripada 49% daripada jumlah saham biasa dalam syarikat itu, maka defendan sebaliknya dikehendaki membuat bayaran tunai untuk nilai saham tersebut melebihi 49%. Dalam erti kata lain, pemilikan plaintif akan dihadkan pada 49%, memandangkan peranannya sebagai pelabur ekuiti swasta. Ia tidak dipertikaikan bahawa syarikat itu gagal memenuhi sasaran keuntungan yang dipersetujui, disebabkan oleh penurunan harga minyak global pada 2014–2016. Plaintif dalam kes ini memohon untuk: (a) perisytiharan berpengaruh bahawa jaminan oleh defendan tentang tahap keuntungan yang disatukan selepas cukai syarikat sebagaimana yang terkandung dalam fasal 20.1 perjanjian pemegang saham telah dilanggar ('permohonan (a)'); (b) defendan memindahkan 4,890,030 saham dalam syarikat itu, selaras dengan

pelaksanaan plaintif hak opsyen panggilannya di bawah perjanjian pemegang saham ('permohonan (b)'); dan (c) defendan adalah untuk membuat bayaran sebanyak RM3,711,340 sebagai pampasan bagi saham yang akan mengambil alih pegangan plaintif melebihi 49% ('permohonan (c)').

Diputuskan, membenarkan sebahagian permohonan plaintif dengan kos RM25,000 tertakluk kepada bayaran alokatur:

(1) Apa yang jelas adalah bahawa yang dimaksudkan oleh pihak-pihak dengan penggunaan istilah yang disatukan merujuk kepada prestasi kumpulan syarikat dan bukan hanya untuk prestasi syarikat secara sendiri. Seorang yang munasabah dalam kedudukan plaintif dan defendan pada masa kontrak itu dimasuki akan memahami 'keuntungan disatukan selepas cukai' bermaksud keuntungan bersih yang dicapai oleh semua syarikat yang terkandung di dalam kumpulan itu, yang merupakan agregat untuk tahun kewangan itu. Sepatutnya tiada perbezaan kepada fasal opsyen panggilan apabila pengambilalihan itu selesai, kerana tujuan pelaburan itu adalah untuk memperoleh faedah daripada usaha ekonomi yang terkandung dalam empat syarikat secara keseluruhannya. Atas sebab itu, angka yang sesuai digunakan untuk keuntungan terkumpul selepas cukai adalah RM8,059,832 dan bukan RM2,756,457 sebagaimana yang dipertikaikan oleh plaintif. Tiada keraguan bahawa audit syarikat telah dijalankan mengikut piawaian perakaunan yang terpakai. Walau bagaimanapun, angka-angka yang diperolehi untuk tujuan perakaunan bukan angka yang akan digunakan untuk tujuan menentukan ukuran keuntungan selepas cukai syarikat yang disatukan yang berkaitan dengan pencetus opsyen panggilan di bawah perjanjian pemegang saham (lihat perenggan 26 & 47–49).

(2) Dengan menggunapakai angka yang sesuai untuk formula opsyen panggilan, mahkamah ditentukan bilangan saham panggilan untuk dipindahkan oleh defendan kepada plaintif sebanyak 2,612,589 saham. Berdasarkan penemuan di atas, mahkamah membenarkan permohonan (a). Walau bagaimanapun, mahkamah membenarkan hanya sebahagian permohonan (b) kerana mahkamah berpendapat bahawa plaintif hanya berhak untuk melaksanakan opsyennya untuk memanggil 2,612,589 saham biasa, selaras dengan pembinaan yang sesuai peruntukan yang berkaitan perjanjian pemegang saham. Saham-saham tersebut, yang diambil bersama dengan pegangan saham sedia ada biasa dalam syarikat itu, tidak akan mengakibatkan plaintif memiliki lebih daripada 49% daripada modal biasa dalam syarikat itu, dan oleh itu mahkamah menolak permohonan (c) (lihat perenggan 51 & 53).]

Notes

For cases on construction in general, see 3(3) *Mallal's Digest* (5th Ed, 2018 Reissue) paras 4623–4634.

Cases referred to

Antaios Cia Naviera SA v Salen Rederierna AB; The Antaios [1985] AC 191, HL (refd)
Arnold v Britton and others [2015] UKSC 36, SC (refd)
Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896, HL (refd)
Prenn v Simmonds [1971] 1 WLR 1381, HL (refd)
Rainy Sky SA and others v Kookmin Bank [2011] UKSC 50, SC (refd)
SPM Membrane Switch Sdn Bhd v Kerajaan Negeri Selangor [2016] 1 MLJ 464, FC (refd)
Sababumi (Sandakan) Sdn Bhd v Datuk Yap Pak Leong [1998] 3 MLJ 151, FC (refd)
Sembcorp Marine Ltd v PPL Holdings [2013] SGCA 43, CA (refd)

Legislation referred to

Evidence Act 1950 s 92(f)

Peter Justin Skelchy (Joyce Pang with him) (Cheah Teh & Su) for the plaintiff.
R Thayakugan (Asha Anandan with him) (Tajuddin & Co) for the defendant.

Azizul Azmi Adnan J:

INTRODUCTION

[1] The plaintiff, MFL International Sdn Bhd, is an investment vehicle of a private equity investor. It invested in Romstar Group Holdings Sdn Bhd ('the company'). The defendant, Encik Baharom Hamzah, is the chief executive of the company. The plaintiff ('MFL') sought to enforce the terms of a profit warranty contained in a shareholders' agreement dated 9 November 2015 ('the shareholders' agreement') entered into between them and certain other shareholders.

[2] I allowed the application in part. MFL has now appealed against this decision.

[3] The key determination in this case centred around the proper construction of a profit warranty clause, specifically the meaning of the expression '(consolidated) profits after tax' as used in the shareholders' agreement. There was a dispute as to the meaning of this phrase because the company only acquired the shares in its operating subsidiaries on 7 December 2015, whereas the profit warranty operated in respect of the financial years 2014–2016. The consolidated net profits of the company for the financial year 2015, as set out in its audited financial statements, only took into account profits attained by the subsidiaries from the date they were acquired. This figure

was, not unexpectedly, appreciably lower than the sum of the net profits of all the three companies put together.

MATERIAL BACKGROUND FACTS

[4] The company holds the entire issued and paid up share capital in three other companies: Romstar Polymer Sdn Bhd, Romstar Sdn Bhd and Romstar Research and Development Sdn Bhd. These companies are engaged in the oil and gas industry. Their business relate primarily to specialised equipment used for the inspection of multi-fuel pipelines.

[5] The shares in the three companies were originally held by the defendant, Norizan Ibrahim, Nur Ashikin bt Ibrahim, Suzanna bt Baharom and Adam Harith bin Baharom. An internal restructuring was carried out to interpose the company as a holding company of the three companies. The shareholders in the three companies executed share swap agreements by which they sold their shares in the various three subsidiaries to the company, in return for which they acquired shares in the company (Norizan, Nur Ashikin, Suzana and Adam are referred to collectively as 'the other shareholders'.)

[6] Concurrently with this internal restructuring, the plaintiff entered into the following agreements:

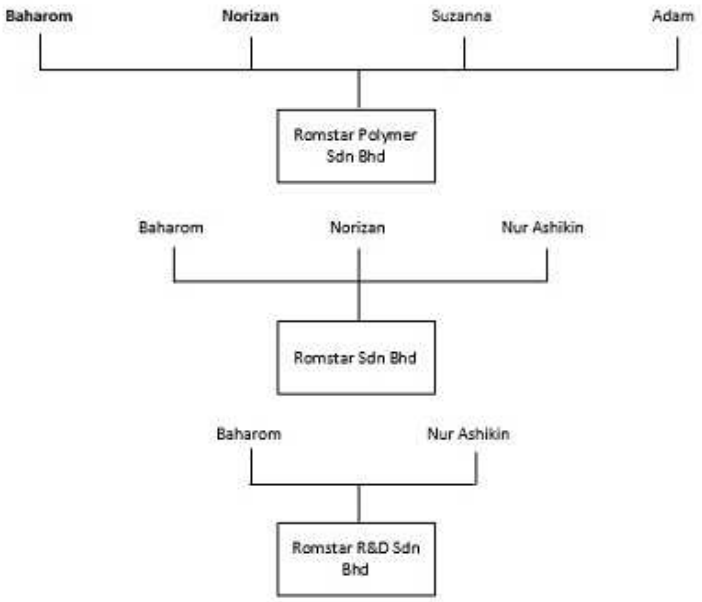
(a) a subscription agreement was entered into between the company, plaintiff, the defendant and the other shareholders for the plaintiff to subscribe for up to 15,800,000 redeemable convertible preference shares ('RCPS') in the company. The subscription was to occur over three stages, with the first subscription of 5,800,000 RCPS to occur within 14 days of the fulfilment of the conditions precedent. The plaintiff had the right, but not the obligation to subscribe for the stage two and stage three RCPS;

(b) a share sale agreement was entered into between the plaintiff and the defendant, by the terms of which the plaintiff purchased 2,997,570 ordinary shares in the company (representing 16.36% of the total ordinary shares in the company) from the defendant for RM6m; and

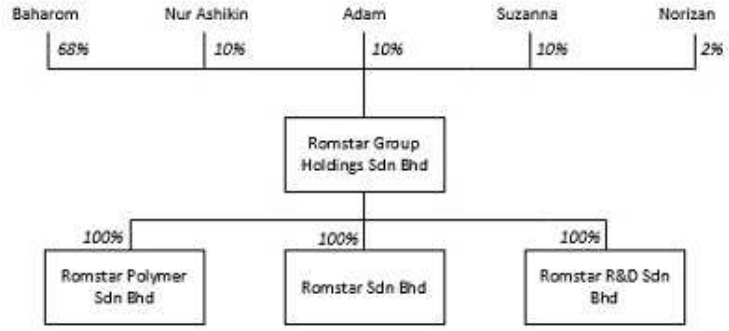
(c) the shareholders' agreement was entered into to govern the relationship of the shareholders in the company.

[7] The effect of the transactions as a whole is more easily understood if illustrated in diagrams.

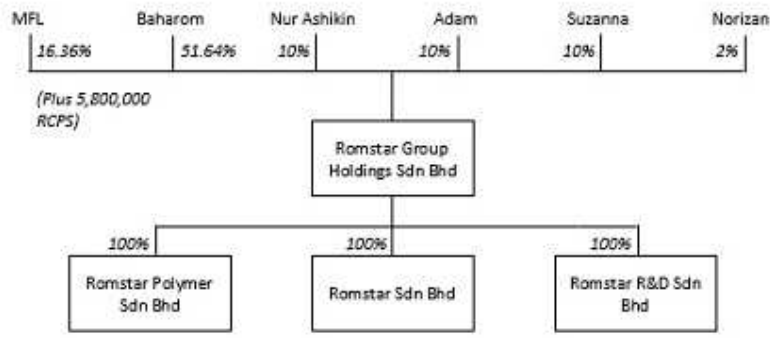
Pre-restructuring (Percentage holdings here are not material to the case):



Post restructuring:



Post acquisition of shares by MFL:



[8] Though the share swaps, the subscription agreement, the share sale agreement and the shareholders' agreement were entered into at the same time, it was contemplated that the transactions would take place sequentially, in the order described above.

[9] The shareholders' agreement contained a call option clause, which essentially operated as a warranty by En Baharom that the consolidated profits after tax of the company would exceed certain specified thresholds. In the event that the target was not met, MFL would be entitled to acquire, for one ringgit, a certain number of shares from En Baharom. This was, as the parties have expressed in the shareholders' agreement, 'to compensate MFL for the over-valuation of the Company'. The number of shares was to be determined in accordance with a prescribed formula.

[10] If the exercise of the call option would result in MFL holding more than 49% of the total ordinary shares in the company, then En Baharom was instead required to make a cash payment for the value of such shares in excess of 49%. In other words, the shareholding of MFL would be capped at 49%, as befitting its role as a private equity investor.

[11] The relevant provisions of shareholders' agreement setting out the call option and the formulae to be applied are set out in the appendix to this judgment.

[12] It was not in dispute that the company failed to meet the agreed profit targets, due to the precipitous downturn in global oil prices experienced in 2014–2016. The vexed question was, by how much?

THE PLAINTIFF'S CLAIM

[13] In its originating summons, MFL sought for, among others, the following reliefs:

(a) a declaration to the effect that the warranty by En Baharom as to the level of consolidated profits after tax of the company as contained in cl 20.1 of the shareholders' agreement had been breached;

(b) En Baharom was to transfer 4,890,030 shares in the company, pursuant to the exercise by MFL of its call option rights under the shareholders' agreement; and

(c) in addition, En Baharom was to make a payment of RM3,711,340 as compensation for the shares that would have otherwise taken MFL's holdings over 49%.

[14] The plaintiff — not unreasonably in my view — relied on the audited financial statements as its basis for the contention that the profit warranty had been breached. The following table sets out the profits after tax of the company as contained in its audited financial statements, compared against the profits that En Baharom had warrantied in cl 20.1 of the shareholders' agreement:

Financial Year	PAT (based on audited financial statements (RM)	PAT (warrantied) (RM)
2014	5,240,000	5,240,000
2015	2,756,457	9,550,000
2016	245,137	15,270,000

[15] Now, it will be recalled that the company was only incorporated on 31 March 2015. Accordingly, there were in fact no audited financial statements for the company for the year ended 31 December 2014. Indeed, the shareholders' agreement itself was signed on 9 November 2015. The figure RM5,240,000 for the consolidated profits after tax for FY2014 was, as I understand it, an agreed figure. In any event, there was no dispute between the parties regarding this sum.

[16] En Baharom did, however, dispute the figures for FY2015 and FY2016.

THE DEFENDANT'S CONTENTIONS

[17] Two main points were advanced for the defendant:

(a) the first was that certain equipment items were incorrectly treated as expenses, when they ought to have been treated as part of the inventory of Romstar Research and Development Sdn Bhd. These items were equipment known as multi-channel calipers and magnetic flux leakage equipment. (The former measures the internal physical dimensions of the fuel pipeline to be inspected, while the latter detects damage to pipes by the use of a powerful magnetic field). The defendant exhibited a report by a firm of chartered accountants engaged to review the financial statements of Romstar Research and Development Sdn Bhd. This report stated that RM1,943,202.94 representing items of a capital nature had been mistakenly treated as expenses, and hence the profits of the company for FY2016 had been understated by this amount.

I dismissed this objection on the basis that it failed for want of proof. There were before me conflicting affidavit evidence on the proper accounting treatment for these items of equipment. In evidence before me was a letter from the solicitors acting for Grant Thornton Malaysia, the auditors of the company, stating that the audit of the company's financial statements for FY2016 had

A been based on the International Standards of Auditing. In the absence of any application for the accountants to be cross-examined, I was of the view that the court was unable to ascertain whether the defendant's assertion was correct. In this regard, I took the view that the evidential burden of proving that there had been a mistake in the treatment of items of a capital nature lay with the B defendant, for it was he who asserted that mistake.

In any event, the defendant has not sought to appeal against my determination of this issue;

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(b) the second contention advanced on behalf of En Baharom was that the correct figure for the consolidated profits after tax of the company ought not have been the figure appearing in its audited financial statements for FY2015. This proposition may appear at first blush to be startling, but is explained D further in the following paragraphs.

[18] It will be recalled that the company was only incorporated on 31 March 2015. Its subsidiaries had been incorporated much earlier and had, by this time, mature businesses that had been running profitably. The reason for the E incorporation of the company, as can be gleaned from the recitals to the various transaction documents, was to consolidate the holdings of all three operating companies under a single holding company, which in turn would facilitate the entry of MFL as the investment vehicle of a private equity investor.

F **[19]** The acquisition by the company of the shares in the three operating subsidiaries were entered into on 9 November 2015, and completed on 7 December 2015. Note 6 to the financial statements for FY2015 (in respect of the item 'investments in subsidiary companies' appearing in the balance sheet) contained the following explanation:

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> The effect of these acquisitions on the income statement of the group
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> From the date of acquisition, acquired a subsidiary company as contributed RM3,920,968 and RM3,567,313 to the Group's revenue and profit net of tax for the financial period respectively. If the acquisition had taken place at the befgining H of financial period, the Group's revenue and profit net tax would have been RM26,996,251 and RM8,059,832 respectively.

[20] From this explanation, it can be seen that the consolidated profits after tax of the company as set out in its audited financial statements for FY2015 (in I the amount of RM2,756,457) only took into account the contributions of the subsidiaries from 7 December 2015 until 31 December 2015. This stands to reason, as the acquisition of the subsidiaries was only completed on 7 December 2015. The aim of financial reporting is to present a true and fair view of the financial situation of a company.

[21] Counsel for the defendant contended that the actual figure for the consolidated profits after tax of the company to be used for the purposes of determining the profit warranty and the call option formula in the shareholders' agreement ought to be RM8,059,832, which represented the sum total of the profits of all the three operating subsidiaries after netting off the losses incurred at the company. The respective figures are set out for ease of reference in the following table:

Financial Year	PAT (based on audited financial statements (RM)	PAT (based on defendant's position) (RM)	PAT (warrantied) (RM)
2014	5,240,000	5,240,000	5,240,000
2015	2,756,457	8,059,832	9,550,000
2016	245,137	245,137	15,270,000

[22] It will be seen from the table above that there will still be a breach of the profit warranty, entitling MFL to exercise its right to call for some of En Baharom's shares at a nominal consideration of one ringgit. However, the number of shares that MFL will be entitled to call is markedly different, depending on which figure is adopted.

ANALYSIS

[23] The key and determinative issue in this case was the meaning of the words '(consolidated) profits after tax' as used in cl 20.1 of the shareholders' agreement. Clause 20.1 reads as follows:

> 20.1 Baharom hereby represents and warrants to MFL that the company shall achieve the following (consolidated) profits after tax ('PAT'):
>
> | Financial Year | PAT |
> |---|---|
> | 2014 | RM5.24 million; |
> | 2015 | RM9.55 million; and |
> | 2016 | RM15.27 million |

[24] The expression '(consolidated) profits after tax' or 'profits after tax' was not defined in the shareholders' agreement. If the agreement had specified that the figure was the consolidated profits after tax of the company as set out in the audited financial statements of the company for the respective financial years, then all that was required was for this figure to be plucked out of the profit and loss statement, and applied in the formula appearing in cl 20 of the shareholders agreement.

[25] There was, in my view, an ambiguity arising from cl 20.1. Was its true construction that as alleged by the plaintiff, which was that the figure to be used

should be the one as audited? Or was En Baharom's construction to be preferred, which was to ignore the fact that the company had only acquired the operating subsidiaries in December 2015, and for the profits and losses of all four companies (ie the three operating subsidiaries and the holding company) for the year be added up to arrive at the actual aggregated profits of the group?

[26] What is clear, however, was that the parties had intended by the use of the term 'consolidated' to refer to the performance of the group of companies, and not just to the performance of the company singly. The question was which consolidated figure was to be used.

[27] In the following paragraphs, I address the applicable principles of construction.

THE PRINCIPLES OF CONSTRUCTION OF CONTRACTS

[28] The recent decision of the Federal Court in *SPM Membrane Switch Sdn Bhd v Kerajaan Negeri Selangor* [2016] 1 MLJ 464 provides a useful summary of the principles to be applied in construing a contract:

> [27] In recent times, the restatement of principles in the landmark case of *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, at pp 912–913 ('ICS') provides a helpful starting point for the consideration of the relevant principles. The judgment of Lord Hoffmann is as reproduced below, where His Lordship stated that:
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> > ... I do not think that the fundamental change which has overtaken this branch of the law, particularly as a result of the speeches of Lord Wilberforce in *Prenn v Simmonds* [1971] 1 WLR 1381, 1384–1386 and *Reardon Smith Line Ltd v Yngvar Hansen-Tangen* [1976] 1 WLR 989, is always sufficiently appreciated. The result has been, subject to one important exception, to assimilate the way in which such documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old intellectual baggage of 'legal' interpretation has been discarded. The principles may be summarised as follows:
> >
> > (1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
> >
> > (2) The background was famously referred to by Lord Wilberforce as the 'matrix of fact', but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the

language of the document would have been understood by a reasonable man.

(3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax: see *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd* [1995] 1 WLR 1 508.

(5) The 'rule' that words should be given their 'natural and ordinary meaning' reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Compania Naviera SA v Salen Rederierna AB* [1985] AC 191 at p 201:

> If detailed semantic and syntactical analysis of words in a commercial contract is going to lead to conclusion that flouts business common sense, it must be made to yield to business common sense.

[28] However, there are reservations to a wholesale adoption and approval of the ICS principles. The applicability of the second ICS principle, specifically vis a vis the question of the admissibility of extrinsic evidence including pre-contractual negotiations, is doubted. This has been alluded to in the recent judgment of this court in *Menta Construction Sdn Bhd v Lestari Puchong* [2015] 6 MLJ 633 for reasons that I will not repeat here. Save for this reservation, the remaining ICS principles are good law.

[29] It is thus clear from the passage quoted above, that extrinsic evidence prior to and at the time of the contract is admissible for the purposes of construing the terms of a contract, subject to certain exceptions. The position under the Evidence Act 1950 is the same as under the common law: see s 92(f) of the Evidence Act 1950, and the speech of Sundaresh Menon CJ in *Sembcorp Marine Ltd v PPL Holdings* [2013] SGCA 43 at paras 45–48.

[30] The object of the exercise of construction is to ascertain the meaning of the contract to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract. The test is thus an objective one: it does not matter what a party had in fact thought that a particular clause meant. The question is what would a reasonable person in the position of that party would have understood by the provision in question.

[31] The background of the transaction serves to put the transaction into context, and this context then used to ascertain what a reasonable person would have understood the words used to mean.

[32] Where there is more than one possible meaning of the words, the court is to prefer the construction that does not offend good business sense. The case of *Prenn v Simmonds* [1971] 1 WLR 1381 (HL) first articulated this concept of good business sense or good commercial sense, and is particularly instructive in the context of the facts of the present dispute.

[33] In this case, Mr Prenn wished to acquire the services of Dr Simmonds, who was the managing director and the leading technician in a company known as Airmec Ltd. Airmec Ltd was a leading manufacturer of radio broadcasting equipment at the time. Airmec Ltd was a wholly-owned subsidiary of another company, then known as Radio & Television Trust Ltd. To effect the acquisition, Mr Prenn acquired 94% of the ordinary shares in Radio & Television Trust Ltd from a public company called Crompton Parkinson Ltd. The agreement to purchase the shares was entered into in July–August 1959. In July 1960, Mr Prenn entered into an agreement with Dr Simmonds granting the latter the right to purchase 4% of the ordinary shares in Radio & Television Trust Ltd subject to the fulfilment of certain conditions. One of the conditions was that:

> The aggregate profits of RTT during the four years ending 19 August 1963 ... shall have amounted to £300,000 after payment or provision for income tax and profits tax...

[34] In modern parlance, this would be described as a call option, intended to secure the services of a key personnel (Dr Simmonds) for a specified period

after the acquisition. The option was to operate as an incentive to Dr Simmonds to remain with Airmec Ltd.

[35] As events turned out, the profits of Radio & Television Trust Ltd was less than £300,000. However, the consolidated profits of Radio & Television Trust Ltd together with Airmec Ltd was more than £300,000. The question was thus whether the precondition to the call option had been triggered, entitling Dr Simmonds to purchase the shares at a discount to the prevailing fair value. The question turned on what the parties meant by 'RTT': did this term refer only to Radio & Television Trust Ltd, or did it refer to the two companies together, taken as a consolidated economic entity?

[36] The House of Lords held that the latter construction was to be preferred, because it better accorded with 'good commercial sense':

> To sum up, Mr Prenn's construction does not fit in any way the aim of the agreement, or correspond with good commercial sense, nor is it, even linguistically, acceptable. The converse of each of these propositions applies to Dr Simmonds's interpretation. I would accept it.

[37] It made good commercial sense for the term 'RTT' to mean the two companies taken together, because Dr Simmonds had an influence over performance of Airmec Ltd, the subsidiary. Accordingly, the call option agreement would have operated as an incentive for Dr Simmonds to ensure that the profits of Airmec Ltd attained a particular level in order for the option entitlement to be triggered. It would have made less sense for the option trigger to be linked to a company over which Dr Simmonds had little or no influence.

[38] In *Rainy Sky SA and others v Kookmin Bank* [2011] UKSC 50, the principles in *Prenn v Simmonds* were applied to a shipbuilding dispute. The UK Supreme Court held that where the parties had used unambiguous language, the court must apply it. Where, however, there are alternative constructions, the court may prefer the one that is consistent with 'business common sense'.

[39] In the passage from the case of *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 quoted by Zainun FCJ in *SPM Membrane Switch v Kerajaan Negeri Selangor,* Lord Hoffman referred to the dicta of Lord Diplock in *Antaios Cia Naviera SA v Salen Rederierna AB; The Antaios* [1985] AC 191, where it was suggested that the words in a commercial contract may be made yield to business common sense. A more recent UK Supreme Court decision suggests that the courts may not be quite so prepared to apply a commonsensical construction that accords with commercial expedience where to do so would go against the plain and unambiguous meaning of the words used.

[40] In *Arnold v Britton and others* [2015] UKSC 36, the claimants were tenants of chalets on a leisure park. The chalets were leased for 99 years at £10 per annum, which would increase by £5 for each successive period of 25 years. The tenants had to pay an annual service charge of £90, which was expressed in some cases to increase on a compounded basis by 10% in each successive year. The tenants argued that this would lead to astronomical charges in the later years of the lease, and could not have been the intention of the parties. Rather, the tenants argued that they were only obliged to pay a proportionate share of actual costs of upkeep, with the £90 operating as a cap on the service fees.

[41] The Supreme Court gave effect to the plain words in the contract (despite the fact that £10 compounded annually would amount to more than £1m at the end of a 99-year lease), holding that commercial common sense and surrounding circumstances should not be invoked to undervalue the importance of the language of the provision to be construed. The less clear the relevant words were, the more ready the court would be to depart from their natural meaning. In addition, commercial common sense was not to be invoked retrospectively. The fact that a contractual arrangement had worked out badly, or even disastrously, for one of the parties was not a reason for departing from the natural language.

[42] A question that thus remains open is whether regard to business common sense, commercial commence sense, good business sense or good commercial sense (I regard these expressions as equipollent) can only be had where there arises an ambiguity in the express words used, or whether good business sense is simply part of the larger process of determining what the reasonable man would have understood the words to mean, given the surrounding circumstances at the time.

[43] I consider this question is not one that was necessary to be answered in the present case, as I am of the view that there clearly is an ambiguity in the words used, as the parties have not defined what they had meant by '(consolidated) profits after tax'.

THE APPLICATION OF THE LAW TO THE FACTS

[44] In the present case before me, the relevant background circumstances are as narrated in paras 4–11, ante. It was clear to me from the context provided by the relevant agreements entered between the various parties that the internal restructuring had been done in order to facilitate the entry of MFL as a minority shareholder in the economic venture represented by the three operating companies, Romstar Sdn Bhd, Romstar Polymer Sdn Bhd and Romstar Research and Development Sdn Bhd. Partly because the shareholdings in these companies were disparate — even though there was

some common shareholders — it became necessary for a holding company to be interposed between the shareholders and the operating companies. This holding company was Romstar Group Holdings Sdn Bhd, the company.

[45] Thus, for the purposes of profit warranty, it made good commercial sense for the call option trigger to be linked to the performance of the four companies as a single economic unit. The interposition of the company as the holding company was merely to facilitate the investment, and its role was simply as an investment holding company without any business activity of its own.

[46] The role of the audited financial statements of the company, by contrast, was to give a true and fair view of the financial situation of the company. For this reason, the profits attributable to the operating companies that were attained prior to the completion of the share swap were not taken into account in order to ascertain the consolidated after tax profits of the company's group. Nonetheless, the auditors considered it appropriate for a note to be included in order to explain what the contributions of the operating companies would have been, had the acquisition been completed at the beginning of FY2015. The objective of the notes to the accounts are the same: so that a true and fair view of the financial situation of the company may be given and obtained.

[47] In my judgment, a reasonable person in the positon of the plaintiff and the defendant at the time the contract was entered into would have understood '(consolidated) profit after tax' to mean the net profits attained by all the companies comprised in the group, aggregated for that financial year. A reasonable person would not have understood cl 20.1 to refer to the figures arising simply because of the accounting treatment applied in order to account for the timing of the acquisition by the company. It should not make a difference to the call option clause when the acquisition was completed, as the purpose of the investment was to obtain the benefits of the economic venture comprised in the four companies as a whole.

[48] For this reason, I found that the appropriate figure to be used for the consolidated profits after tax was RM8,059,832 and not RM2,756,457 as contended by MFL.

[49] It is important to understand that I am in no way suggesting the company's accounts for FY2015 are in error or that Grant Thornton Malaysia was in any way wrong to have arrived at the consolidated after tax profits as stated in the profit and loss statement of the company. I have no doubt that the audit of the company had been conducted in accordance with the applicable accounting standards. I am, however, of the view that the figures arrived at for

accounting purposes are not the figures to be used for the purposes of ascertaining the measure of consolidated after tax profits of the company in connection with the call option trigger under the shareholders' agreement.

[50] In oral arguments before me, Mr Skelchy for the plaintiff pointed to cl 6.2 of the shareholders' agreement in support for his contention that the parties had intended to apply the consolidated after tax profits as set out in the financial statements of the company for the purposes of determining compliance with the profit warranty. Clause 6.2 merely provided that the financial year end of the companies in the group was to be 31 December of each year. I did not see how this clause was material to the determination of the question in issue.

THE APPLICATION OF THE FORMULA

[51] Applying the appropriate figure to the call option formula, I determined the number of call shares to be transferred by En Baharom to MFL to be 2,612,589 shares. The transfer of these shares to MFL would not result in it holding more than 49% of the ordinary capital in the company, hence there would not be any payment to be made pursuant to cl 20.4 of the shareholders' agreement.

[52] The calculations are set out as follows.

Final weighted average PAT for 2014, 2015 and 2016

Financial Year	Profits after tax (RM)	Agreed Weighting		Weighted Profits (RM)
2014	5,240,000	1	=	5,240,000
2015	8,059,832	1.5	=	12,089,748
2016	245,137	1.75	=	428,990
Total				17,758,738

Final Weighted Average PAT

= 17,758,738 ÷ (1 + 1.5 + 1.75)

= RM4,178,526.53

Percentage shares to be transferred

$$= \frac{5{,}800{,}000}{6 \times 4{,}178{,}526.53} - \frac{5{,}800{,}000}{65{,}350{,}000}$$

$$= 14.2588648\%$$

= 14.2588648%

Number of shares to be transferred

= Total number of shares in issue x 14.2588648%

= 18,322,557 ordinary shares x 14.2588648%

= 2,612,589 ordinary shares

[53] For the reasons explained above, I allowed the plaintiff's prayer for a declaration to the effect En Baharom had failed to meet his profit warranty as contained in cl 20.1 of the shareholders' agreement. I allowed prayer (b) of the originating summons in part only, as I was of the view that the plaintiff was only entitled to exercise its option to call for 2,612,589 ordinary shares, in accordance with the proper construction of the relevant provisions of the shareholders' agreement. These shares, taken together with the plaintiff's pre-existing holdings of ordinary shares in the company, would not have resulted in plaintiff owning more than 49% of the ordinary capital in the company, and hence I disallowed the claim in prayer (c).

The inter-relation between implied terms and the construction of a contract

[54] It was apparent to me that the issue in dispute between the parties could have been analysed in two ways:

(a) the first is the approach employed at para 23, which was that the words used by the parties were ambiguous and capable of supporting two alternative meanings. In order to ascertain the meaning of those words, I have examined the background circumstances and considered which of the two meanings better accorded with good business sense; or

(b) secondly, it may also be possible to approach the issue as one concerning the implication of terms. The parties had used a particular form of words, but had failed to define this expression. There was therefore a gap in the contract, whereupon it may fall upon the court to infer the existence of an implied term.

[55] In my judgment, even if the case is analysed from the perspective of implied terms, the result would have been the same. Both the business efficacy test and the officious bystander test would have arrived at the conclusion that the applicable figure to be used would be the actual profits after tax figures aggregated for the four companies in respect of FY2015, without regard to the fact that the acquisition by the company of its operating subsidiaries was only completed on 7 December 2015.

[56] The mere existence of a gap in a contract does not automatically mean that a term ought to be inferred to address that gap. In *Sembcorp Marine Ltd v PPL Holdings*, the Singapore Court of Appeal explains the applicable

principles:

> Although the prayer to imply a term might imply that there is a gap in a contract, which needs to be filled, not all gaps in a contract are 'true' gaps in the sense that they can be remedied by the implication of a term. There are at least three ways in which a gap could arise:
>
> (a) the parties did not contemplate the issue at all and so left a gap;
>
> (b) the parties contemplated the issue but chose not to provide a term for it because they mistakenly thought that the express terms of the contract had adequately addressed it; and
>
> (c) the parties contemplated the issue but chose not to provide any term for it because they could not agree on a solution.
>
> 95. In our view, scenario (a) is the only instance where it would be appropriate for the court to even consider if it will imply a term into the parties' contract (see *Socimer International Bank Ltd (In Liquidation) v Standard Bank London Ltd (No 2)* [2008] 1 Lloyd's Rep 558 at [105]). This pertains to what the parties would be presumed to have agreed on had the gap been pointed out to them at the time of the contract. Scenario (c) is not a proper instance for implication because the parties had actually considered the gap but were unable to agree and therefore left the gap as it was. To imply a term would go against their actual intentions.
>
> 96. Scenario (b), also, is not a proper situation in which to imply a term. What drives this scenario is not the parties' presumed intentions, but rather their objectively ascertained actual intentions. Oftentimes, what is sought to be corrected through the process of implication is the mistaken belief that 'the document accurately records the transaction' (see for instance, *Etablissements Georges et Paul Levy v Adderley Navigation Co Panama SA (The 'Olympic Pride')* [1980] 2 Lloyd's Rep 67 at 72). The proper remedy for such a situation is the rectification of the instrument in equity: see *Codelfa Construction Prop Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at p 348.

[57] If the failure to specify what was meant by '(consolidated) profits and loss' was a gap that was not contemplated by the parties at all, then the appropriate course was to apply the accepted tests for the implication of terms, as laid out by the Federal Court in *Sababumi (Sandakan) Sdn Bhd v Datuk Yap Pak Leong* [1998] 3 MLJ 151. This comes within scenario (a) described by Menon CJ in *Sembcorp*'s case.

[58] If the parties had contemplated the issue arising from the failure to specify the meaning of the expression '(consolidated) profits and loss', but had come to the mistaken conclusion that the express terms of the shareholders' agreement had addressed the issue, then the court would apply the tests applicable in properly construing the terms of the agreement, as I have done in para 44. This is scenario (b) described in *Sembcorp*'s case.

[59] Scenario (c) does not arise in the present case, as no evidence was led that the parties had considered the issue arising from the use of the expression '(consolidated) profits after tax' but had pointedly left the issue unresolved.

[60] In *Sababumi (Sandakan) Sdn Bhd v Datuk Yap Pak Leong*, the Federal Court held that, in order for the court to infer the existence of an implied term, both the officious bystander test and the business efficacy tests must be fulfilled.

[61] I find that, if the hypothetical officious bystander had raised the question of what was meant by the term '(consolidated) profits and loss', the parties, having addressed their minds to the issue, must have necessarily come to the conclusion that it was the substance of the contribution of each component company in the group to the net profits that must be the appropriate measure for the call option trigger.

[62] Similarly, the same conclusion was necessary in order to give business efficacy to the transaction. There was, in my view, no commercial justification of using the accounting treatment applied to the financial statements of the company. If the contention of the plaintiff was correct, then the timing of the completion of the share swap agreements would have materially affected the final consolidated net profit figures, which is an untenable position. Why would the timing of the acquisition have made a difference, since the parties had clearly intended for the profits even before the consolidation of the group under a single holding company to be taken into account? The substance of the transaction was for MFL to obtain exposure to the economic venture comprised in the three operating companies, and the holding company structure was simply a means to facilitate that investment. The timing of the acquisition was therefore irrelevant.

[63] I allowed the plaintiff costs of RM25,000, which costs were subject to an allocatur.

The plaintiff's application allowed in part with costs of RM25,000 subject to the payment of allocator.

Reported by Mohd Kamarul Anwar